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TREASURY FOR INTERNATIONAL AFFAIRS - MMILLS AND CPLANTIER
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TAGS: EFIN PGOV TU
SUBJECT: TURKEY'S PENSION REFORM

REF: ANKARA 2161 AND PREVIOUS

¶1. (SBU) Summary: The Turkish government has submitted to Parliament a major reform of Turkey's social security institutions. The reform--a requirement of IFI programs--will consolidate three separate social security agencies into one, aligning the three systems' parameters on a less costly glide path, and thereby setting the stage for a long-term decline in Turkey's large social security deficits as a percent of GNP, currently 4.5 percent. Despite delays in sending the legislation to parliament, the Government appears to have recognized the need for reform now, while Turkey's relatively young population eases the transition to more sustainable parameters, reining in the excessive generosity of the current system. The cost savings of combining the three systems, combined with the very gradual adjustments in parameters used in calculating pension payments, will mean few Turks will feel the change in the short run. One notable exception will be civil servants, especially high-level civil servants, whose generous pension system is being aligned with the less generous system used for private sector employees. The reform has yet to provoke much protest, perhaps because only the civil servants will feel a significant impact, and they are in a weak position to demand better treatment than other employees. End Summary.

The GOT Bites the Bullet of Pension Reform:

¶2. (SBU) Earlier this month, the GOT finally submitted long-awaited Health and Pension Reform legislation to Parliament, fulfilling one of three prior actions required for the new $10 billion IMF program. The social security reform had been in preparation since before last summer, when the Ministry of Labor and Social Security released a "white paper" prepared in close coordination with the World Bank. Though in recent months the focus has been on the delays since a December agreement with the IMF staff on the outlines of a new IMF program, the big news is that the Social Security reform is a major structural reform that, over time, should put Turkey's retirement and health systems on a much more sustainable basis. In recent years, the combined deficits of Turkey's three social security institutions reached 4.5 percent of GNP. The deficits were not only large, but were increasing: the pension deficit alone rose from 2.5 percent of GNP in 2000 to 3.5 percent of GNP in 2004, and were projected to rise to 7 percent of GNP in the absence of reform. These deficits have been a major contributor to Turkey's financial problems. According to the white paper, the resources used to finance the deficits in the last ten years equate to 1.24 times Turkey's consolidated debt stock. The white paper also makes a convincing case that now is the time for Turkey to move to a more sustainable system, while it has a relatively young population that can support its smaller retiree age group during the transition: only in 2012 will 7 percent of Turkey's population be over 65 years old, a threshold reached by the U.S. in 1945. By 2039, however, 14 percent of Turkey's population will be over 65.

Earlier Governments' (Mosty Bad) Policies:

¶3. (SBU) The Social Security situation is a microcosm of the economic policy quandary faced by the AKP government: earlier governments' irresponsible or inept policies left a fiscally-unsustainable legacy that AKP has to take politically-unpopular steps to correct. In the early 1990s, Prime Minister Demirel changed the pension rules to allow people to receive pension payments as early as age 42 for men and 38 for women. This has meant legions of Turks drawing pensions while still in their forties. This feature was reformed in 1999, when the retirement ages were raised to 60 for men and 58 for women, but with a very long-term phase in, such that people are still retiring in their forties. Other parameters were not altered significantly in the 1999 reform. As a result, the reform was inadequate. In addition to its excessive generosity, Turkey's social security system is

inefficient because it consists of three separate agencies, one for civil servants, one for self-employed and farmers, and one for all other employees.

Dialogue with the IFI's:

¶4. (SBU) In order to see through this very difficult reform, the GOT made the inspired decision in 2003--encouraged by the IFI's--to transfer Tuncay Teksoz, the Treasury economist following social security issues, to the Ministry of Labor and Social Security and give him responsibility for shepherding the reform. Teksoz assembled a team of economists from Treasury and the Central Bank who recognized the severity of the problem and did both the technical work and consulted with stakeholders, patiently explaining the need for the changes. Though the political level sometimes quibbled over how to implement the reform, and in December 2003 Prime Minister Erdogan exacerbated the social security deficit with an above-inflation increase in payments, having Teksoz and his technocrats running the process helped get a consensus around the unavoidable need to rein in the deficit.

¶5. (SBU) Social security and IFI officials have told us that when there were frictions with the IFIs over the social security reforms in recent months, it was mostly about the assumptions used in the elaborate World Bank-provided model--there were 585 variables. When the GOT tried to use more optimistic growth assumptions, for example, it took some of the pressure off of how harsh the parametric changes (see below) needed to be. The IFIs pushed back, however, and eventually agreement was reached.

¶6. (SBU) The IFIs left the exact mix of parametric changes to the GOT, relying on the model to come up with a menu of options for a given overall cost reduction, and leaving the politically-delicate decisions on which parameters to change to the GOT. Instead, there are near-, medium-, and long-term targets under the IMF program, expressed in terms of the overall social security deficit to GNP. For the coming three years, the target is to keep the deficit at no more than 4.5 percent of GNP, the idea being that if nothing were done the deficit would surpass this threshold. Over ten years, by 2015, the target is to achieve a cost savings on the pension component equivalent to close to 1 percent of GNP. In the long run, the goal is to bring the overall social security deficit under 1 percent of GNP.

Projected Deficit of Retirement System (in percent of GDP):

	2005	2010	2020	2030	2040	2050
Without reform:	3.6	3.5	3.7	4.0	5.8	7.0
With reform:	3.4	2.9	2.2	1.5	0.6	0.1

The Devil is in the Parameters;

¶7. (SBU) The above targets are to be achieved from a combination of parametric changes and cost-saving efficiencies from the merger of the three institutions--Bag-Kur (for self-employed and farmers), Emekli Sandigi (for civil servants) and Social Security (for everyone else). There are five parameters affecting the cost of the pension payments:

--valuation of wages: the value placed on a lifetime of wages in order to determine the size of the retirement pension payment. In a country like Turkey, which has experienced near-hyperinflation, it can make a big difference whether the rate of growth of wages or that of prices (i.e. inflation) is used to value past wages.

--indexation of benefits: how much pension payments increase during retirement.

--replacement ratio: the size of pension benefit a worker receives in retirement for each year worked.

--years required to receive full benefit.

--retirement age: the age at which one can retire and be eligible for pension payments.

¶8. (SBU) In the end, the GOT managed to make the reform politically palatable by finding a formula that would achieve the targets without many Turks feeling a significant near-term impact. The GOT accomplished this by leaving already-vested rights alone, and only gradually applying the new formulae to future earnings. New entrants to the labor force, on the other hand, will be entirely subject to the new regime. As for future pain, the main group that will see a

sharp reduction in what it would have expected to receive upon retirement are civil servants, especially high-level civil servants. The civil servants' plan was more generous in several respects: replacement ratio, indexation, and work-years required to qualify (see below). Teksoz pointed out it would be awkward for the civil servants to protest over no longer getting preferential treatment: in 2004 the civil servants' pension plan's deficit was about TL 8 Quadrillion ($5.7 billion), while the total deficit of the other systems' was TL 11 Quadrillion ($7.6 billion), despite the fact that civil servants accounted for only 15 percent of total employees in all three systems.

¶9. (SBU) In general, the reform achieves savings by aligning all three systems around less costly parameters:

--Valuation of wages will be based an equal weighting of wage growth and inflation (CPI basis). This was reportedly a compromise between the IFI's and the GOT, with the former wanting the slower-growing inflation rate and the GOT wanting wage growth.

--Indexation of benefits: pension payments will increase in line with the CPI rate of inflation, whereas both civil servants and farmers in the Bag-Kur system were indexed to more costly wage growth.

--Replacement ratio: Whereas the civil servants had earned 3 percent of their salary in pension payments for every year worked, the other systems earned less. Under the new system all will earn 2.5 percent until 2016, and 2 percent thereafter. In addition, civil servants' pensions were calculated based on their final salary. Under the new, unified system pension calculations will be based on an employees average salary during their entire working life, substantially reducing the size of the pension payment.

--Retirement age/years required to receive full benefit: all systems will require 9000 days worked, with a continual phase-in of the 1999 retirement age requirement, followed by increasingly older retirement ages beginning in 2035. The higher retirement age after 2035 is being justified in terms of projected increases in life expectancy. Though this will achieve little savings in the near-term, in the long run it is a crucial change from Turkey's very early retirement age.

¶10. (SBU) The IFI and Turkish experts expect the targeted cost savings to be achieved over time through a combination of the above-described parametric changes and substantial savings from the merger of the three separate systems. The actual merger of the three systems will require additional legislation but Teksoz told us the plan would be to have a unified agency by the beginning of 2006. In addition to the efficiency gains from combining three separate systems into one, Treasury and Social Security officials say that a single system will be better able to track people who fail to pay their premia, or who fradulently receive pensions from more than one system.

¶11. (SBU) Comment and Conclusion: The pension reform is a major step forward, putting the country on a glide path--albeit a gradual one--to a sustainable, less costly pension system. It is one area of reform in which the GOT seems to have real ownership, having recognized the need to take action while Turkey still has a relatively young population. Pension reform also has the benefit of simplifying Turkey's currently complicated retirement system.

EDELMAN